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In the Supreme Court
OF THE
United States

OCTOBER TERM, 1967

Nos. 760 and 781

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,
vs.
IRVING GORDON and MARGARET GORDON,
Respondents.
} No. 760

On Writ of Certiorari to the United States Court of Appeals for the Second Circuit

OSCAR E. BAAN and EVELYN K. BAAN,
Petitioners,
vs.
COMMISSIONER OF INTERNAL REVENUE,
Respondent.
} No. 781

On Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

BRIEF OF RESPONDENTS IN NO. 760 AND OF PETITIONERS IN NO. 781

OPINIONS BELOW

The findings of fact and opinion of the Tax Court in the two consolidated cases (A. 227)[1] are reported at 45 T.C. 71. In No. 760, the opinion of the Court of Appeals for the Second Circuit (A. 275) is reported at 382 F.2d 499. In No. 781, the opinion of the Court of Appeals for the Ninth Circuit (A. 308) is reported at 382 F.2d 485.

JURISDICTION

In No. 760, the judgment of the Court of Appeals for the Second Circuit (A. 306) was entered July 26, 1967. The petition for certiorari was filed by the Commissioner of Internal Revenue ("Commissioner") October 23, 1967, and was granted January 15, 1968.

In No. 781, the judgment of the Court of Appeals for the Ninth Circuit (A. 334) was entered July 7, 1967. Rehearing was denied August 15, 1967 (A. 10). The petition for certiorari was filed by Oscar E. and Evelyn K. Baan ("taxpayers")[2] November 2, 1967, and was granted January 15, 1968.

The jurisdiction of this Court is invoked under section 1254(1) of Title 28 of the United States Code.

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[1]References in this form are to pages of the Consolidated Appendix prepared pursuant to Rule 36.

[2]The term "taxpayers" will likewise be used herein to refer to respondents in Docket No. 760, Irving and Margaret Gordon.

STATUTES INVOLVED

The case directly concerns the application of section 355[3] of the Internal Revenue Code of 1954 (26 U.S.C. 355 (1964 Ed.); 68A Stat. 113-114), which is set forth in Appendix A, infra, pages v to ix.

QUESTIONS PRESENTED

The Pacific Telephone and Telegraph Company ("Pacific"), engaged in the telephone business in California, Oregon, Washington and Idaho,[4] adopted a plan of reorganization to divide its business between its California operations and those in the other three states. As a first step, Pacific formed Pacific Northwest Bell Telephone Company ("Northwest"), to take over the non-California business of Pacific. Then, pursuant to the plan, it distributed all of the stock of Northwest, by issuing pro rata to the Pacific shareholders, in two offerings, short-term transferable rights to purchase all of such stock. More than 95 per cent of the rights were exercised by the same Pacific shareholders to whom they were issued, and all were eventually exercised. The question presented is whether the taxpayers (common shareholders of Pacific), who exercised their Northwest rights to retain their proportionate equity in Pacific and Northwest, thereby received dividend income, despite the provisions of section

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[3]References hereinafter to numbered sections, without further specification, are to sections of the Internal Revenue Code of 1954 (26 U.S.C. (1964 Ed.)).

[4]Pacific also owns all of the stock of Bell Telephone Company of Nevada which operates in Nevada. The Nevada subsidiary and its operations are irrelevant to the cases at bar and hence are disregarded.

355. The Tax Court and the Second Circuit Court of Appeals held that the tax-free spin-off provisions of section 355 applied and that the taxpayers did not receive any dividend income through the exercise of their rights. The Ninth Circuit Court of Appeals sustained the Commissioner's contention that section 355 did not apply, and held that the taxpayers received dividend income equal to the difference between the fair market value of the Northwest stock when the rights were exercised and the amount paid to Pacific.

As a further reason for not applying section 355, the Ninth Circuit Court of Appeals held that the two offerings of the Northwest stock by Pacific were not parts of a single transaction, contrary to the requirements of section 355(a)(1)(D). A subsidiary question is presented whether the Ninth Circuit erred in making this factual determination directly contrary to the determination of the Tax Court, which is amply supported by the record.

In Docket No. 760, taxpayers sold some of their Northwest rights, and the additional question is presented whether the sale resulted in capital gain, as contended by the taxpayers and held by the Court of Appeals for the Second Circuit, or dividend income, as contended by the Commissioner and held by the Tax Court.

STATEMENT OF THE CASE

Summary Statement

In 1961 Pacific, which for many years had engaged in the telephone business in California, Oregon, Washington and Idaho, decided for purely business reasons to

divide the Oregon, Washington and Idaho operations from those in California (A. 35, 49). One of the methods considered by Pacific's management to effect this division was a conventional spin-off which clearly would have qualified under section 355 (A. 182-183). In such a spin-off, assets of the corporation are transferred to a newly organized subsidiary in exchange for stock, which is then distributed to the shareholders of the parent without the surrender by them of stock in the parent corporation. This method was rejected because of obstacles under state corporation law (A. 183-184). Instead, Pacific adopted a plan of reorganization whereby the assets in the three states in the Pacific Northwest were transferred to a new corporation, Northwest, and all of the stock of Northwest was spun off by means of the pro rata issuance to the Pacific shareholders of rights to purchase Northwest stock (A. 100, 103-104). The use of rights at the same time satisfied the needs of Pacific for additional capital for its expanding California operations (A. 104, n.).

Pursuant to the plan, in 1961 Pacific offered 57 per cent of the Northwest stock to its shareholders on the basis of six rights plus $16 for each share of Northwest, and in 1963 all of the remaining Northwest stock on the basis of eight rights plus $16 a share (A. 56, 61). During the 21-day offering period in 1961, the Northwest shares had a market value ranging from $25.25 to $28.25 per share (A. 139).

American Telephone and Telegraph Company ("American"), owned approximately 90 per cent of the stock of Pacific (A. 39). Under the plan, American stated its intention to exercise all of its rights to acquire Northwest

stock (A. 109). When the plan of reorganization had been fully carried out, more than 95 per cent of the Northwest stock was received through the exercise of rights by Pacific shareholders to whom such rights were issued (A. 62, 141). Pacific continued to operate its business in California (A. 35), and Northwest continued the operation of the businesses formerly conducted by Pacific in Oregon, Washington and Idaho (A. 66). To the extent that Pacific common shareholders, such as taxpayers, exercised rights issued to them, they retained their same proportionate interest in the businesses conducted by Pacific in the States of California, Oregon, Washington and Idaho, as before the division, except that instead of owning solely shares of Pacific, they owned shares in Pacific evidencing their interest in the California operations, and shares in Northwest evidencing their interest in the Oregon, Washington and Idaho operations. Not only was there no change in their proportionate equity in Pacific and Northwest, but they had in addition made a cash contribution to the capital of Pacific at the rate of $16 for each share of Northwest stock.

The Commissioner ruled that section 355 did not apply to the distribution of the Northwest stock through the issuance of stock rights (A. 153, 159). In the case of corporate shareholders of Pacific, the Commissioner ruled that they would receive dividend income under section 301(b)(1)(B), if the basis of the Northwest stock in the hands of Pacific was in excess of $16 a share required to be paid in the exercise of rights (A. 153, 159). Since such basis of the Northwest shares was less than $16 per share, corporate shareholders (including American) under

the Commissioner's ruling were not considered as having received any taxable income through the receipt of their Northwest stock (A. 123). However, in the case of individual shareholders, the Commissioner ruled that they received dividend income under section 301 equal to the difference between $16 a share and the market value of the Northwest shares at the time of exercise of their rights (A. 153, 159). The deficiencies involved in these proceedings were determined against the taxpayers on this basis (A. 26).

The Tax Court, contrary to the position taken by the Commissioner, held that section 355 applied to the distribution of the Northwest stock (A. 257). The Commissioner sought review of the *Gordon* case in the Second Circuit and the *Baan* case in the Ninth Circuit. The Second Circuit Court of Appeals affirmed the Tax Court's holding that section 355 applied (A. 295). That court stated that it was evident that the taxpayers' investment remained in corporate solution, merely changed in form, that the additional factor of the payment of $16 per share was in essence a contribution to capital which provided no occasion for the imposition of a tax (A. 284-285). It found, in accordance with the decision of *Palmer v. Commissioner* (1937) 302 U.S. 63, that no distribution of corporate property occurred until the Northwest rights were exercised, and thereupon the Northwest stock was distributed with respect to the Pacific stock (A. 286). It determined that section 355 did not require a single distribution of stock of the controlled corporation and that the distribution of the Northwest stock through two rights offerings was to be considered a single transaction (A. 290-295). It found that

the transactions fully satisfied the purpose of section 355, and that on the contrary, the Commissioner's determination would convert equity capital into ordinary income (A. 285).

The Court of Appeals for the Ninth Circuit, however, held that section 355 did not apply, on the ground that the receipt of the Northwest stock was not a distribution solely of stock or securities with respect to Pacific stock (A. 327). It held that there was a distribution of stock rights taxable as a dividend under section 301 and not of stock or securities, distinguishing the *Palmer* case (A. 319-323). The Ninth Circuit, as an additional ground for reversal of the Tax Court, held that the conditions of section 355(a)(1)(D) were not satisfied. It held that the two distributions were not entitled to treatment as a single transaction, on the ground that "such distributions must not extend over any greater period of time than is reasonably necessary considering the practical problems involved in completing such distributions" (A. 333).

This Court granted certiorari to resolve the conflict (A. 335, 336). The technical questions presented in the terms of section 355 are as follows:

Was the receipt by taxpayers of Northwest stock through the exercise of stock rights a distribution solely of stock or securities with respect to their Pacific stock, within the meaning of section 355(a)(1)(A)?

Did Northwest acquire its business and assets from Pacific in a transaction in which no gain or loss was recognized (section 355(b)(2)(C)), so as to satisfy the active business requirements of section 355(a)(1)(C)?

Did the distributions by Pacific of all of the Northwest stock through two rights offerings in 1961 and 1963 pursuant to a plan of reorganization satisfy the provisions of section 355(a)(1)(D) as distributions of all of the stock in a controlled corporation?

In Docket No. 760 the question is presented whether the proceeds of sale of the Northwest rights are taxable as a dividend, or whether such sale gave rise to a capital gain, as held by the Second Circuit Court of Appeals.

Detailed Statement

Taxpayers Irving Gordon and Margaret Gordon, husband and wife and residents of New York City, throughout 1961 owned 1,540 shares of the common stock of The Pacific Telephone and Telegraph Company ("Pacific") (A. 34, 68).

Taxpayers Oscar E. Baan and Evelyn K. Baan, husband and wife and residents of Sausalito, California, throughout 1961 owned 600 shares of the common stock of Pacific (A. 34, 67).

Pacific is a California corporation which for several decades prior to July 1, 1961, furnished communications services including local and long-distance telephone services in the States of California, Oregon and Washington and a northern portion of Idaho (A. 35).

Throughout 1961 Pacific had outstanding: 820,000 shares of preferred stock, par value $100, entitled to seven votes per share; and 104,756,943 shares of common stock, par value $14-2/7, entitled to one vote per share (A. 36). Pacific also had a long-term funded debt of $902,000,000 (A. 37). In 1961, American Telephone and Telegraph

Company ("American"), a New York corporation, owned about 90 per cent of Pacific's common stock and about 78 per cent of its preferred stock (A. 37, 39). In addition, the remaining portions of Pacific's common and preferred stock were owned by more than 38,000 minority shareholders (A. 39).

Following World War II, Pacific's business expanded enormously, with every prospect of continued growth at the same rate (A. 45-46). Between the end of World War II and January 1, 1961, the number of telephones which it served increased from 2,700,000 to about 8,000,000; its gross investment in telephone plant increased from \$662,000,000 to \$3,402,000,000; and annual operating revenues increased from \$243,000,000 to \$1,120,000.000 (A. 45-46). Pacific was the eighth largest nonfinancial company in the United States (A. 46). Its operating territory included one seventh of the continental United States (A. 182).

Pacific's mushrooming growth during this period required a constant in-pouring of capital funds. In each of the seven 12-month periods which preceded June 30, 1960, Pacific had issued common stock and/or long-term debentures in the total amount of nearly \$1-⅓ billion, averaging almost \$200,000,000 for each of the seven years (A. 47). The prospect of continued growth assured a need for new capital at approximately the same rate in 1961 and the years immediately following (A. 191).

The growth and enormous size of Pacific generated severe administrative problems, and caused much concern that the company was getting too big to do an effective job (A. 88, 211). In 1958, Pacific's Vice President and Comptroller, John O. Einerman, undertook studies looking

toward division of Pacific into two or three corporations (A. 182). These studies culminated in a plan for reorganization, which Pacific's directors adopted on January 27, 1961, on Mr. Einerman's recommendation (A. 49).

The plan of reorganization provided basically for the division of the Oregon-Washington-Idaho business, leaving the California business to be continued by Pacific (A. 102). The plan provided that Pacific would cause a new corporation to be organized in the State of Washington (ultimately named Pacific Northwest Bell Telephone Company and herein called "Northwest") which would issue 30,460,000 shares of $11 par capital stock, having an aggregate par value of $335,060,000, and a note to be refunded by permanent-debt financing (A. 50, 52). The objective in this regard was to result in a capital structure for Northwest similar to that of Pacific (A. 54).

The plan provided that Pacific would transfer all of its business and properties in Oregon, Washington and Idaho to Northwest, in exchange for (a) the assumption by Northwest of certain operating liabilities relating to the assets transferred; (b) all of Northwest's capital stock; and (c) Northwest's $200,000,000 demand note bearing 4-½ per cent interest (A. 52, 103, 104). The advantages of having the business in Oregon, Washington and Idaho operated by a separate corporation based in the State of Washington were considered to be: bringing top authority closer to the communities served, with a board of directors having final authority and drawn from the territory served; better recognition of service needs of each community; closer relations and better understanding as between the company and customers, employees, and govern-

ing authorities; more efficient operations; the assumption of financing and operating problems by Northwest's management; and freeing Pacific's management to concentrate full attention on the needs of California (and, through its subsidiary, Nevada) (A. 88-89).

Before adopting the plan, Pacific's management considered various alternative proposals for distribution of the Northwest shares. One such proposal was the distribution of the Northwest shares to Pacific's shareholders without payment by them of any consideration. This was dropped because of obstacles under California law of which Pacific's management was advised by its counsel[5] (A. 182-184). Since Pacific was advised that the only feasible method of accomplishing the distribution of the Northwest shares to its shareholders, consistent with California law, was through rights offerings, Pacific coupled the stock distribution with the raising of needed capital for its expanding operations in California.

To achieve its purpose, therefore, the plan provided that all of the Northwest stock would be offered to the Pacific shareholders through rights (A. 103-104).

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[5]Pacific's attorneys advised that if the Northwest shares should be distributed to Pacific's shareholders without payment of any consideration by them, under California law the distribution would have to be charged to earned surplus, and Pacific had insufficient earned surplus for this purpose. While Pacific's management was advised that it could create a reduction surplus out of capital, against which a distribution of the Northwest shares could be charged, such a reduction surplus would be required under California law to be used first to redeem all of Pacific's preferred shares. Pacific's management was advised and believed that under California law Pacific could not call its preferred shares for redemption. It was not feasible to redeem Pacific's preferred shares by voluntary tender or purchase (A. 183-184).

A first offering of 57.3 per cent of the shares was provided to take place in 1961, with the remainder to be offered in one or two later offerings, as determined by Pacific's board of directors, as Pacific's capital needs developed (A. 108-109).

Pacific's board of directors on January 27, 1961, resolved to submit the plan to Pacific's shareholders for consideration at the annual meeting on March 24, 1961 (A. 49). In February and March, 1961, Pacific requested from the Commissioner of Internal Revenue rulings as to the tax effects of carrying out the plan upon Pacific, American and Pacific's shareholders (A. 71). Rulings (summarized below) were forthcoming June 28, 1961, two days before the closing date of the transaction and the take-over by Northwest of the Oregon, Washington and Idaho business and properties (A. 146, 155).

On March 24, 1961, Pacific's shareholders heard Mr. Einerman's explanation and recommendation of the plan, and approved it, subject to its approval by the appropriate regulatory authorities of the states involved (A. 49).

After obtaining the necessary approvals of the regulatory authorities,[6] Pacific caused the organization of Northwest on March 27, 1961 (A. 50). Pacific was the sole shareholder of Northwest from March 28, 1961, until after

[6]At the time Pacific, and since that time Northwest, were each subject to regulation in each state in which they operated, by a state public utility regulatory authority having jurisdiction over many aspects of the business, including security issues, purchases and sales of property and the like. Both are likewise subject to regulation by the Federal Communications Commission to the extent their business is interstate (A. 35-36).

the rights offering to its shareholders on September 29, 1961 (A. 56).[7]

As stated above, the Commissioner on June 28, 1961, issued a ruling letter (A. 146) in response to Pacific's requests for rulings in February and March. The Commissioner ruled that section 355 would not apply to the receipt by the Pacific shareholders of Northwest stock upon exercise of the rights to be issued by Pacific (A. 153); that the receipt of the Northwest rights by the Pacific shareholders would not result in taxable income to the shareholders (A. 152); that the receipt by the Pacific shareholders of Northwest stock upon the exercise of their rights, in the case of non-corporate shareholders, would result in a distribution of property under section 301 in an amount equal to the excess of the fair market value of the Northwest stock at the time of their exercise of rights over the $16 paid for the stock; and, in the case of corporate shareholders, would result in a taxable distribution of property under section 301 in an amount equal to the excess, if any, of the basis of the Northwest stock in the hands of Pacific over the $16 paid for the stock[8] (A. 152-153).

The above rulings were reaffirmed in all respects by the Commissioner's letter dated November 15, 1962 (A. 158-159).

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[7]On March 28, 1961, Northwest issued 10,000 shares of its stock to Pacific in return for $110,000 in cash (A. 50). An additional 30,450,000 shares of Northwest's stock passed to Pacific, together with the $200,000,000 note, on June 30, 1961 (A. 52).

[8]As later shown (infra, p. 56), the basis of the Northwest stock in the hands of Pacific was less than $16; hence under the Commissioner's ruling corporate shareholders, including American, did not receive a taxable distribution.

Pursuant to the plan, on June 30, 1961, Pacific transferred all of its business and properties in Oregon, Washington and Idaho to Northwest in exchange for the consideration contemplated by the plan. Thereupon, Pacific ceased, and Northwest commenced, operation of the telephone business in Oregon, Washington and Idaho (A. 52-53).

At a meeting of Pacific's directors on August 25, 1961, Mr. Einerman presented his recommendation of an offering price for the first portion of Northwest stock (A. 58). He presented to the board a number of factors for consideration (A. 129-131), aimed generally at solving the practical problems of affording reasonable assurance that substantially all of the rights would be exercised (A. 206-207) and Pacific's immediate capital requirements met (A. 207-209), and that the reorganization could be accomplished as planned with the least disturbance to Pacific's shareholders (A. 192-193). In behalf of Pacific's management Mr. Einerman recommended to the board, after giving appropriate weight to all factors, that the offering price for the Northwest stock then to be distributed be set at $16 plus six rights (A. 131-132). The board approved the recommendation and the rights were issued accordingly (A. 56-57, 58). Mr. Einerman testified that he did not intend to recommend that a dividend distribution be made (A. 188, 190).

As above indicated, the total capitalization of Northwest was arranged in such a way as to maintain substantially the same ratios of stock, aggregate debt and surplus as those of Pacific immediately prior to the transfer of assets (A. 54). The $200,000,000 demand note of North-

west corresponded to the long-term debentures in the capital structure of Pacific (A. 53). The plan provided that within about three years Northwest would refund the demand note through issuance of its own long-term debentures to the public (A. 109-110). Pursuant to the plan, this refinancing was carried out through four issues of 20-year debentures of Northwest of $50,000,000 each, the last issue occurring in December, 1963 (A. 66).

The plan contemplated that American would exercise all of the rights it was entitled to receive and that American, after consummation of the plan, would own about the same percentage of the Northwest stock as its percentage of ownership of Pacific stock (A. 90-91). Pacific's directors and shareholders were advised, at the time of receiving and approving the plan, of this expectation (A. 109).

Pursuant to the plan, on September 29, 1961, Pacific issued to its shareholders of record on September 20, 1961, rights evidenced by assignable warrants to purchase 57.3 per cent of the Northwest stock, on payment of six rights and $16 per share (A. 56-57). This amount of the initial distribution was fixed in order to pass legal control of Northwest to American immediately (A. 209-210). At the same time, the capital to be raised by Pacific in connection with this distribution was considered not in excess of what Pacific could reasonably use in its business operations at that time (A. 208-209). The rights would expire, if not exercised, on October 20, 1961 (A. 57). Both the capital stock of Northwest and the rights were listed for trading on the American and Pacific Coast stock ex-

changes, and trading with respect to each commenced, at first on a when-issued basis, on September 14, 1961 (A. 58).

The Gordons exercised all except four of their 1,540 rights on October 5, 1961, and paid Pacific $4,096, and received 256 shares of Northwest (A. 69). The Gordons sold the remaining four rights, receiving net proceeds of $6.36 (A. 69). In their joint Federal income tax return for 1961, the Gordons reported no income or loss from the receipt, exercise or sale of the Northwest rights or from receipt of the Northwest stock (A. 69). On the day the rights were issued (September 29, 1961), the market value of the Northwest stock as determined by public trading was $26.81, and the market value of each right as similarly determined was $1.77. On October 5, 1961, the day the Gordons exercised their rights, the two values were $26 and $1.66, respectively (A. 139-140).

The Baans exercised all of their 600 rights on October 11, 1961, paid Pacific $1,600 and received 100 shares of Northwest stock (A. 68). In their joint Federal income tax return for 1961, the Baans reported no income or loss from either the receipt or exercise of the Northwest rights or from receipt of the Northwest stock (A. 68). On October 11, 1961, the day the Baans exercised their rights, the market value of the Northwest stock, as determined by public trading, was $26.94 and the market value of the rights as similarly determined was $1.80 (A. 139-140).

As called for by the plan, American exercised all the rights which it received in 1961, and acquired 15,548,140 shares of Northwest. The minority common and preferred

shareholders of Pacific exercised rights to acquire 1,897,-891 Northwest shares (A. 57).

Further pursuant to the plan, on April 22, 1963, Pacific's board of directors resolved to offer to Pacific's shareholders the remaining 42.7 per cent of Northwest stock held by Pacific. The offering price this time was set at $16 plus eight rights per share. Rights were issued on June 12, 1963, exercisable at any time before the close of business on July 3, 1963 (A. 61). As contemplated by the plan, American exercised all of the rights it received, and upon completion of the plan owned about 89 per cent of the capital stock of Northwest (A. 62). The minority common and preferred shareholders of Pacific to whom rights were issued owned another six per cent (A. 141).

As mentioned below, the Tax Court found that the two offerings of Northwest stock were component parts of a single plan and that they must be regarded together as resulting in the disposition of 100 per cent of the Northwest stock (A. 255, n. 4).

On the 1961 consolidated income tax return filed by American and its subsidiaries, the transfer of assets from Pacific to Northwest was treated as a transaction coming under section 351. Since both Pacific and Northwest were included in a consolidated return in the year of the transfer, no gain or loss was reported on that transaction (A. 245). Also, no gain was reported on the sale by Pacific to American of the Northwest shares for which American exercised its rights. Pacific did report gain on the sale of the Northwest shares to Pacific's minority shareholders to the extent of the difference between the $16 price and Pacific's basis for the property transferred to Northwest,

apportioned to the shares as to which the gain was reported[9] (A. 248).

The Gordons, in their 1961 income tax return, reported no income in respect of their receipt, exercise or sale of their rights (A. 69). Treating the difference between $16 per share and the traded value of Northwest stock on the day when they exercised their rights ($26.00) as a dividend, the Commissioner assessed a deficiency of $895.10, in accordance with his earlier ruling letter (A. 26).

The Baans, in their 1961 income tax return, reported no income on the receipt or exercise of their rights (A. 68). Treating the difference between $16 per share and the traded value of Northwest stock on the date of exercise of the rights ($26.94) as a dividend, the Commissioner assessed a deficiency in the amount of $284.44 (A. 228).

On the taxpayers' petitions for redetermination, the Tax Court decided that the taxpayers did not receive taxable dividend income in respect to receipt or exercise of the rights. It found that the two offerings of Northwest stock were component parts of a single plan and that they must be regarded together as resulting in the disposition of all of the Northwest stock previously owned by Pacific (A. 255, n. 4). The court held that if Pacific had distributed the Northwest stock without consideration to its own shareholders, the distribution would have qualified as a classic case of a tax-free divisive reorganization under section 355, and that neither the use of stock rights nor the presence of Northwest's $200,000,000 note required a different result under section 355. The court noted the absence of

[9] Also involved in the apportionment were the Northwest note and the assumption of liabilities.

any contention that the transaction was used as a "device for the distribution of the earnings and profits" of either Pacific or Northwest (A. 260).

Regarding the Government's contention that section 355 was not satisfied since Pacific did not "distribute" the Northwest stock but rather distributed rights to purchase the Northwest shares, and that the stock of Northwest was in any event not distributed "with respect to its [Pacific's] stock," the Tax Court said:

> "The Government's position is based upon a highly technical and inhospitable reading of the statute that fails to give effect to the basic objective that Congress sought to achieve. This case concededly involves a spin-off. Pacific plainly divested itself of the business which it had conducted in the three northwest states" (A. 262).

The situation, the Tax Court held, was not changed merely because the distribution was conditioned upon payment of $16 a share by the distributees; it was nonetheless a distribution of Northwest stock to the taxpayers "with respect to" their ownership of stock in Pacific. The stock of Northwest was literally "distributed" to the taxpayers, albeit for a consideration, and the statute should not be construed to depart from that literal meaning, where to do so would frustrate the legislative purpose (A. 262).

As for the Government's argument that the subject of the distribution was the rights to subscribe rather than the Northwest stock itself, the Tax Court pointed out that *Palmer v. Commissioner*, supra, 302 U.S. 63 makes it clear that the issuance of the rights is not in itself a dis-

tribution of corporate earnings and profits; if any income were to be charged it would have to be regarded as stemming from the receipt of the Northwest stock on exercise of the rights; but since section 355 was intended to permit the receipt of such stock without tax even where the recipient paid nothing therefor, it would be a distortion of Congressional purpose to impute an intention to tax where the recipient was required in effect to contribute capital to the distributing corporation as a condition to receiving the distributed stock (A. 263).

Continuing with its sentence-by-sentence analysis of section 355, the Tax Court found (1) that the five-year active business requirements were met (A. 264); (2) that the transaction whereby Northwest acquired its business from Pacific was not one in which gain or loss was recognized, in view of the fact that no gain or loss was required to be included in the consolidated return filed by American and its subsidiaries (A. 269); and (3) that as part of the distribution Pacific effectively distributed all of the stock in the controlled corporation (Northwest) held by it immediately before the distribution (A. 270).

Finally, the Tax Court held that the proceeds received by the Gordons from the sale of four rights was dividend income, since shareholders who sold their rights did not come under section 355 in respect thereto (A. 271).

As stated above, on petitions for review the Court of Appeals for the Second Circuit affirmed the Tax Court in all respects (A. 295) except as to the sale of the rights, which the court held came under the capital gains provisions of the Internal Revenue Code rather than the dividend provisions (A. 296). The court noted particularly the

absence of dispute that (1) the Pacific-Northwest corporate division fulfilled a valid business purpose, (2) the method selected by Pacific to accomplish the division was dictated by valid business reasons, and (3) that there was no possibility under the transaction for turning ordinary income into capital gains—the evil which section 355 was designed to prevent (A. 282). While Congress hedged in the use of section 355 with a number of conditions to prevent a tax-avoidance bail-out of earnings and profits, "when the division presents no opportunity for a bail-out, these conditions should not be so construed as to frustrate the basic Congressional purpose" (A. 283).

In summary, the court said it was evident that the taxpayers' investment remained in corporate solution (aside from the $6.36 representing proceeds of sale of rights) and merely changed its form; the only additional factor was the $16-per-share contribution to capital, which was no occasion for the imposition of the tax. Conversely, if the Commissioner should prevail, the taxpayers' equity investment would be turned into ordinary income (A. 284-285). Having in mind these effects, and the fundamental Congressional purpose of taxing income when and as received, the court was satisfied that all of the technical provisions of section 355 were met (A. 285).

The Court of Appeals for the Ninth Circuit disagreed, looking upon section 355 as a very narrowly defined set of conditions which had to be followed, with nothing added or subtracted, if the transaction was to qualify (A. 318). With this approach, the court concluded that while a distribution to the distributing corporation's shareholders without consideration would qualify (A. 320), a distribu-

tion with consideration paid by the shareholders—even though it left the shareholders with less than before—was dividend "income" and therefore taxable; in other words, that it could not constitute a "distribution with respect to" Pacific's stock (A. 327). It considered that a distribution of rights was a distribution of property taxable as a dividend under section 301 (A. 321).

As an independent ground for reversal, while it held that a single distribution was not required under section 355, the court ruled that the two distributions violated a requirement newly conceived by the court that qualified distributions under section 355 could not take longer than is reasonably necessary considering the practical problems involved in completing such distributions (A. 333).

The writs of certiorari bring these divergent views before this Court.

SUMMARY OF ARGUMENT

For compelling business reasons, Pacific adopted a plan to divide its telephone business in four western states between itself and a new corporation, Northwest, while preserving stock ownership of both corporations in the Pacific shareholders. Obstacles under California corporation law prevented Pacific from merely transferring part of its business to Northwest and distributing the Northwest stock pro rata, in the most common form of spin-off (divisive) reorganization. It accomplished the same result

through the mechanism of two rights offerings of all the Northwest stock to its shareholders pro rata, thereby serving the collateral purpose of raising additional capital needed to service Pacific's growth in California.

The stock rights mechanism neither altered the purpose and effect of Pacific's plan as a divisive reorganization, nor served to distribute to the Pacific shareholders any part of the corporate assets or net worth. When the plan was completed, all of the Northwest stock—but nothing else—had been distributed, over 95 per cent of it to Pacific shareholders, representing their same proportionate interest in the business and assets transferred to Northwest. Here was a legitimate divisive reorganization for corporate business reasons, which section 355 was designed to make tax free, entailing none of the tax-avoidance features which section 355 was designed to prevent.

The legislative history of section 355 demonstrates the Congressional purpose to liberalize existing law as to nonrecognition of gain in cases involving mere rearrangement of the corporate structure. Congress intended to permit the widest latitude in the forms and mechanics of divisive reorganizations when effected for sound business reasons, subject to specified safeguards to prevent tax avoidance. Congress was concerned with results, not mechanics, so that the same tax consequences would attach where substantially the same results were achieved. The conditions set forth in section 355 are designed to thwart abuse of the section by disguised distributions of earnings and profits; however, the Commissioner has conceded throughout this case that Pacific's plan of reorganization was *not* a "device" for distributing earnings and profits.

Measured against the broad Congressional objectives and safeguards, the plan fully satisfies the purposes of section 355. To disqualify it because it involved the *payment* of cash *by* the Pacific shareholders is at war with the Congressional purpose to do away with technical niceties of form or corporate mechanics. Even if the Pacific shareholders had *received* cash from Pacific in addition to the Northwest stock, the gain taxed would have been limited to such cash under section 356. Congress could not have intended that they be taxed when they received *nothing* but the Northwest stock, and instead had to *pay out* cash to Pacific.

Neither the receipt nor the exercise of the Northwest stock rights represented any distribution of the earnings and profits of the two corporations. Under prior decisions of this Court, including *Palmer v. Commissioner* (1937) 302 U.S. 63, the mere receipt of stock rights by shareholders is not a dividend, because no distribution of corporate assets results in any practical sense, even though the rights have a market value. The rule of the *Palmer* case is now firmly embedded in the tax law and in established administrative practice. Lower court decisions have long held that stock rights may be used as an incidental corporate mechanism for effecting reorganizations and do not prevent them from qualifying as tax free reorganizations. The *Palmer* principle was applied by the Commissioner in the advance rulings issued to Pacific in the cases at bar.

The Northwest stock rights were but short-term offers, transitory steps to effect the distribution of all the Northwest stock. The only corporate assets transferred by their exercise were the shares of Northwest stock, representing

a changed form of the shareholders' equity in Pacific's assets. Far from diminishing corporate net worth, the exercise of the rights increased net worth by the capital thus paid in to Pacific. Pacific's shareholders were left with two pieces of paper instead of one, to evidence their continued ownership in the same assets. There was nothing here resembling any bail-out of earnings and profits, since the taxpayers' investment remained in corporate solution, augmented by their capital contribution.

A distribution of all of the Northwest stock to the Pacific shareholders without the payment of cash by them, if it had been possible, would clearly qualify as a tax-free spin-off. A simple contribution of cash to the capital of a corporation by its shareholders is likewise a tax-free event. To transmute these two tax-free transactions into taxable income when they are combined in a single plan of reorganization contradicts substance and reality. The Congressional purpose is to tax income. Until the taxpayers dispose of their Northwest stock, they have not enjoyed any income from the receipt of such stock.

The Commissioner's theory in this case has several elements of harshness. It requires the payment of a tax when the shareholders have received nothing out of which to pay the tax, except the evidences of their continuing equity. It seeks to transmute that equity into ordinary income. It produces unrealistic results in regard to the taxpayers' basis in their Pacific and Northwest stock, and Pacific's earnings and profits available for future distribution. In contrast, the taxpayers' theory results in no detriment to the revenue, and fully accords with the reality of the transactions.

The power of the distributees to sell their rights or to sell a part of their stock in either Pacific or Northwest is irrelevant under section 355 in the absence of a prearrangement to sell. If the mere power to sell their equity were the test, no divisive reorganization could ever qualify. Here, over 95 per cent of the Northwest stock in fact went to Pacific shareholders who exercised rights, thereby preserving their equity.

The contention that the phrase "distributes * * * with respect to its stock" in section 355 prohibits the payment by the shareholders of a consideration, has no merit. This phrase in Subchapter C, the corporate provisions of the Code, simply refers to a distribution to shareholders in their capacity as shareholders. The Pacific shareholders received the Northwest stock in their capacity as Pacific shareholders. Neither the provisions of section 355 nor any other provision of the statute expressly prohibits consideration. As this Court said in *Palmer*, a sale of corporate assets to shareholders is literally a distribution of corporate property to them. In contending that the Northwest stock distribution is a "distribution * * * with respect to stock" within section 301 and hence a dividend under that section, the Commissioner contradicts his contention that such distribution does not fit the identical words in section 355.

Pacific and Northwest satisfied the "active business" requirement of section 355, in that no new assets and no new corporation were acquired from others. Internal adjustment of corporate assets, such as Pacific's transfer of assets to Northwest here, are irrelevant to section 355. Further, the gain which might otherwise have been com-

puted on Pacific's transfer was properly "eliminated" in the consolidated Federal income tax return in which Pacific joined. As the Tax Court held, "elimination" of an "unrealized gain" is synonymous with "nonrecognition," a term used throughout the Code which merely denotes that a specified gain or loss is not to be taken into account.

Nothing on the face of section 355 limits the number of distributions of the stock of the controlled corporation, nor their timing. The Tax Court correctly found that Pacific's two distributions, in 1961 and 1963, were integral steps in a single transaction by which all of the Northwest stock passed from Pacific, satisfying the literal requirements of the statute and its purpose. The Commissioner's belated legal argument in the courts of appeals, that only one distribution is permitted under section 355, was properly rejected by both courts. The general doctrine applicable to all reorganizations that integral steps in carrying out a plan of reorganization must be treated as parts of a single transaction is applicable here. The Ninth Circuit committed gross error in ignoring the Tax Court's factual determination, and in holding that the 1961 and 1963 distributions were not parts of a single transaction.

In selling four rights, the taxpayers in No. 760 sold something representing their right to preserve their equity in the 20 per cent of its business and assets which Pacific had transferred to Northwest. The proceeds of the sale should therefore be treated as a capital gain, in accordance with the analogy of section 1234(a) and the anticipatory assignment cases.

ARGUMENT

I

THE RESULT OF THE DISTRIBUTION OF THE NORTHWEST STOCK TO PACIFIC'S SHAREHOLDERS THROUGH THE TWO RIGHTS OFFERINGS WAS A SPIN-OFF REORGANIZATION WHICH CONGRESS INTENDED TO BE TAX-FREE UNDER SECTION 355.

A. Pacific's divisive reorganization was in purpose and effect a tax-free spin-off which Congress intended to permit under section 355.

Pacific, for compelling business reasons, conceived a plan of reorganization to divide the business and assets of Pacific into two corporations, keeping the stock ownership for practical purposes unchanged. The plan contemplated that these two corporations would have separate managements and be owned separately by the Pacific shareholders. Pacific was advised by its attorneys that under the California corporation law it was unable to effect this divisive reorganization by transferring the assets and business of Pacific in the three northwest states to a new corporation, Northwest, and simply distributing the stock of Northwest to the Pacific shareholders pro rata (A. 183). Had it done so, this would have been what the Tax Court correctly referred to as a classic case of a tax-free divisive reorganization or spin-off permitted under section 355 (A. 260). This is undisputed by all concerned.

A spin-off in its common form, as described by the Ninth Circuit (A. 316), is a transaction in which a part of the assets of a corporation is transferred to a new corporation, and the stock of the transferee is distributed to the shareholders of the transferor without surrender by them of any stock in the transferor. The basic elements are the transfer of assets to a newly organized subsidiary and the

receipt of the subsidiary's stock by the shareholders of the parent corporation. The presence here of the first of these basic elements, namely, the transfer of the business and assets of Pacific in the three northwest states to a new corporation, Northwest, is undisputed.

Pacific, however, was precluded by California corporation law from employing the corporate mechanism more commonly used, namely, a transfer of the Northwest stock to its shareholders by means of a dividend out of its surplus. What Pacific could not achieve by direct distribution of the Northwest stock out of its surplus, it was able to accomplish consistently with state law through the mechanism of prorata rights offerings of all the Northwest stock to its shareholders. While the rights served a collateral purpose of raising additional capital for Pacific to meet its expanding needs in California, the rights were essential to accomplish the divisive spin-off of the Northwest stock in a manner consistent with the state corporation law. Through the rights offerings the Pacific shareholders were enabled to receive the Northwest stock which the plan of reorganization contemplated be distributed to them.

The use of the stock rights in no way altered the purpose and effect of the plan of reorganization as a divisive spin-off reorganization. There was no plan proposed, nor was there any intention on the part of Pacific (A. 188, 190), to distribute earnings and profits to its shareholders. The plan contemplated that the shareholders would receive and retain, after the plan was completed, nothing but Northwest stock, in addition to their Pacific stock. After the spin-off of the Northwest stock, the ag-

gregate property and net worth of Pacific and Northwest were in no wise diminished. The primary purpose of the plan of reorganization was to enable the Pacific shareholders to retain the same proportionate interest in the equity of Pacific and Northwest after the reorganization as each had before. This purpose was fulfilled, since the Pacific shareholders, for all practical purposes, retained their same equity in the two corporations. Over 95 per cent of the Northwest stock went to the Pacific shareholders, including taxpayers, through the exercise of the rights issued to them (A. 62, 141).

The Second Circuit properly characterized the transaction as a legitimate spin-off serving only corporate business purposes, which entailed none of the tax-avoidance features that section 355 was designed to prevent (A. 282). The reorganization achieved precisely what section 355 was intended to permit: a division of the assets and business of Pacific for business purposes, and a spin-off of the stock representing such assets and business to the Pacific shareholders.

B. The legislative history of section 355 establishes that the distribution of the Northwest stock fully satisfies the Congressional purposes of that section.

From the Revenue Act of 1918 forward, tax-free divisive reorganizations have been permitted. Such reorganizations took three forms: so-called split-offs, split-ups and spin-offs. These three types of divisive reorganizations in their common forms are described in the opinion of the Ninth Circuit (A. 318).

In a split-up, a corporation transfers substantially all of its assets to two or more corporations and then liqui-

dates, its stockholders surrendering all of their stock in the transferor and receiving the stock in the transferee corporations. In a spin-off, part of the assets of a corporation are transferred to a new corporation, and the stock of the transferee is distributed to the shareholders of the transferor without the surrender by them of stock in the transferor. A split-off is the same as a spin-off, with the exception that the shareholders surrender part of their stock in the parent corporation in exchange for the newly created subsidary.

Until the Revenue Act of 1924, there was no express provision for a tax-free spin-off. Since Congress felt that spin-offs were economically indistinguishable from split-offs and split-ups which could be effected without the recognition of gain under then-existing law, Congress expressly provided for tax-free spin-offs in section 203(c) of the Revenue Act of 1924 (H.Rept. 179, 68th Cong., 1st Sess., p. 14).

It soon became apparent that the form of tax-free spin-off delineated in section 203(c) of the Revenue Act of 1924 could be used as a tax-avoidance device for distributing earnings and profits in the form of capital gains. This device was dealt with, and struck down, by this Court in *Gregory v. Helvering* (1935) 293 U.S. 465. In that case, without any bona fide corporate business purpose and solely for tax avoidance, a corporation transferred securities to a new corporation, the stock of which was distributed to the taxpayer, who immediately liquidated the new corporation. The purpose of the transaction was to obtain the securities as a capital gain rather than as a taxable dividend.

The difficulty, under the statute as it then stood, of distinguishing between spin-offs serving legitimate business needs and those designed for tax avoidance led Congress, in the Revenue Act of 1934, to eliminate spin-offs completely as tax-free divisive reorganizations (S.Rept. 558, 73d Cong., 2d Sess., p. 16). Congress still continued to permit tax-free split-ups and split-offs.

In 1951, however, Congress reinstated tax-free spin-offs, recognizing that it was "economically unsound to impede spin-offs which break up businesses into a greater number of enterprises when undertaken for legitimate business purposes" (S.Rept. 781, 82d Cong., 1st Sess., p. 58). Section 112(b)(11), added in 1951 to the 1939 Code, provided for tax-free spin-offs if they were not principally used as a device for distributing earnings and profits.

In 1954, in enacting the new Internal Revenue Code, Congress thoroughly re-examined the existing law relating to all corporate distributions and adjustments. Subchapter C represented an overhaul of existing law in this area. One of the basic objectives of Subchapter C was to liberalize existing law with respect to the nonrecognition of gain in cases which involve mere rearrangements of the corporate structure.[10] Congress placed in a single section (section 355 involved herein) the provisions dealing with all tax-free

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[10]"The House bill in this area is, in substance, an entirely new statute using few of the terms or concepts with which the courts or the bar have become familiar over the years. Your committee has sought a less extreme approach. Rather than to replace the existing statute, it has sought to rewrite it so as to preserve the terms and concepts of existing law wherever possible. It has, however, not hesitated to depart from the present statute where such departure was necessary in order to *remove unwarranted restrictions on necessary or desirable business transactions* or to preclude

divisive reorganizations—split-offs and split-ups as well as spin-offs.

The legislative history of this section clearly reveals a Congressional purpose to encourage divisive reorganizations effected for legitimate business purposes (H.Rept. 1337, 83d Cong., 2d Sess., pp. 40, A120-A122; S.Rept. 1622, 83d Cong., 2d Sess., pp. 50, 266-267). Subject to safeguards to prevent the abuse of divisive reorganizations as a device to distribute earnings and profits, Congress intended that the widest latitude be permitted in the forms and methods used in carrying out such reorganizations on a tax-free basis. It swept aside the formal distinctions between spin-offs, split-ups and split-offs. Congress evidenced its concern only with results, and not corporate forms or mechanics. Congress plainly desired that the same tax consequences would attach to different types of transactions accomplishing substantially the same result. The House Ways and Means Committee report states:

> "Your committee's bill is designed to insure that the same tax consequences result from the different types of transactions which are available to accomplish substantially the same result" (H.Rept. 1337, 83d Cong., 2d Sess., p. 39).

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the use of avoidance devices which have proved successful under the existing code. Thus, your committee would *liberalize present law with respect to the nonrecognition of gain or loss in cases which involve mere rearrangements of the corporate structure* while at the same time providing less liberal rules in other areas in order to insure that transactions which are in substance, although not in form, dividend distributions by corporations to their shareholders are subject to tax at ordinary income rather than at capital gain rates" (S.Rept. 1622, 83d Cong., 2d Sess., p. 42, emphasis added; to like effect, H.Rept. 1337, 83d Cong., 2d Sess., p. 34).

The Congressional determination to remove impediments to tax-free divisive reorganizations is apparent from the changes made in prior law. By section 355(a)(2)(A), Congress made it no longer necessary to have pro-rata distributions of stock. Section 355(a)(2)(B) dispensed with the necessity for surrendering stock in the distributing corporation. Section 355(a)(2)(C) removed any requirement that the distribution be made pursuant to a plan of reorganization. Under prior law it had been considered necessary to create a new holding company in order to distribute its stock under a tax-free spin-off. Congress eliminated this requirement and permitted the stock of a controlled corporation to be distributed directly on a tax-free basis. Congress even permitted the retention of some stock of a controlled corporation, whereas under prior law it had been considered that all of such stock had to be distributed to qualify as a tax-free spin-off (S.Rept. 1622, 83d Cong., 2d Sess., pp. 266-267). All of these changes, dispensing with formal and mechanical requirements, were made subject to one overriding principle, namely, that the transaction not be used as a device for the distribution of earnings and profits.[11]

Four conditions are enumerated in section 355, each designed to implement the purpose of Congress in thwarting the distribution of earnings and profits. Under section

[11] "While your committee intends generally in section 353 [section 355 as finally enacted] to permit freedom in the distribution of stock of controlled corporations, subsection (b) is included in the bill to insure that tax avoidance will not result by reason of a later disposition of the stock so acquired" (H.Rept. 1337, 83d Cong., 2d Sess., p. A122).

355(a)(1)(A), only stock or securities of a controlled corporation can be received tax free. Under section 355(a)(1)(B) the transaction cannot be used principally as a device for the distribution of earnings and profits. Section 355(a)(1)(C) prevents the acquisition of a business which might be spun off and thereby serve as a means of distributing earnings and profits. Lastly, section 355(a)(1)(D) was designed to prevent the retention of shares in pursuance of a plan having as its principal purpose the avoidance of Federal income tax.

So much did Congress wish to encourage and liberalize tax-free divisive reorganizations, that even where cash or other property is received by the shareholders in addition to stock and securities of a controlled corporation, such receipt will not disqualify the tax-free receipt of the stock or securities. Section 356 provides that only to the extent of the cash or other property received by the shareholders in addition to stock or securities in a divisive reorganization is gain to be recognized to them. Moreover, section 355 permits the tax-free spin-off of preferred stock and securities, whereas under prior law only common stock could be the subject of a tax-free spin-off (S.Rept. 1622, 83d Cong., 2d Sess., p. 267).

Measured against these broad Congressional objectives and safeguards, Pacific's plan of reorganization fully satisfies the purposes of section 355. The plan was conceived and carried out purely for corporate business reasons. It could not possibly be characterized as a "device" for distributing earnings or profits of Pacific or Northwest. To disqualify the Pacific divisive reorganization because it involved stock rights and the *payment* of cash *by* the Pacific shareholders is at war with the Congressional purpose of

permitting tax-free bona fide spin-offs without regard to technical niceties of form or corporate mechanics.

If, in addition to receiving Northwest stock, Pacific shareholders had *received* cash from Pacific, no gain would arise from the receipt of the Northwest stock, and they would be charged with gain only to the extent of the cash received (section 356). Surely Congress did not intend that they should be taxed when they received nothing but the Northwest spin-off stock, and not only had *not received* cash, but had in fact *paid it out*.

Under these circumstances, the Tax Court was clearly correct when it concluded (A. 262):

> "The Government's position is based upon a highly technical and inhospitable reading of the statute that fails to give effect to the basic objective that Congress sought to achieve. This case concededly involves a spin-off. Pacific plainly divested itself of the business which it had conducted in the three northwest states. Had it distributed the Northwest stock directly to its stockholders without consideration there would clearly have been the type of divisive reorganization contemplated by the statute, at least as far as subparagraph (A) is concerned. And, in our view, the situation is not changed merely because that distribution was conditioned upon payment of $16 a share by the distributees. It was nonetheless a distribution of Northwest stock to these petitioners, stockholders in Pacific, made 'with respect to' their ownership of stock in Pacific. If Congress had intended that a distribution of the Northwest stock be treated as tax-free when made without consideration, it is inconceivable that it could have intended the transaction to result in taxable income to the distributees where they *paid out* money in connection

with receiving such stock. The stock of Northwest was literally 'distributed' to petitioners, albeit for a consideration, and we hold that the statute should not be construed so as to depart from such literal meaning, where to do so would frustrate the legislative purpose" (emphasis by the court).

C. The distribution of the Northwest stock did not and could not effect any distribution of earnings and profits by Pacific to its shareholders.

The Commissioner has contended that section 355 does not apply to the distribution of the Northwest stock. His position, concurred in by the Ninth Circuit, is that taxpayers who exercised their rights to acquire the Northwest stock thereby received dividend income, taxable under section 301. That section provides that a distribution of property by a corporation to a shareholder with respect to its stock will constitute a dividend to the extent that it is a distribution of earnings and profits.

In the classic case of *Eisner v. Macomber* (1920) 252 U.S. 189, this Court, in examining the nature of dividend income, stated that no dividend income is received by a stockholder if he receives nothing out of the company's assets for his separate use and benefit. This was followed by the case of *Miles v. Safe Deposit Co.* (1922) 259 U.S. 247, in which the Court dealt with the question whether the receipt of stock rights constituted the receipt of dividend income. The Court said (pp. 251-252):

> "It is evident, we think, that such a distribution [of rights] in and of itself constituted no division of any part of the accumulated profits or surplus of the company, or even of its capital; it was in effect an opportunity given to stockholders to share in con-

tributing additional capital, not to participate in distribution. * * * This privilege of itself was not a fruit of stock ownership in the nature of a profit; nor was it a division of any part of the assets of the company.

"The right to subscribe to the new stock was but a right to participate, in preference to strangers and on equal terms with other existing stockholders, in the privilege of contributing new capital called for by the corporation * * *."

While the *Safe Deposit Co.* case dealt with rights to acquire stock of the same corporation, the same rule that the mere receipt of stock rights is not income applies equally to rights to purchase the stock of another corporation. This was established by the decision of this Court in *Palmer v. Commissioner* (1937) 302 U.S. 63, which resolved the conflicting views of the lower courts on this point. In *Palmer* the Court stated (302 U.S. 71):

"*First.* The mere issue of rights to subscribe and their receipt by stockholders, is not a dividend. No distribution of corporate assets or diminution of the net worth of the corporation results in any practical sense. Even though the rights have a market or exchange value, they are not dividends within the statutory definition. Cf. *Miles v. Safe Deposit & T. Co.,* 259 U.S. 247; *Helvering v. San Joaquin Co.,* 297 U.S. 496; *Helvering v. Bartlett, supra.* They are at most options or continuing offers, potential sources of income to the stockholders through the sale or exercise of the rights. Taxable income might result from their sale, but distribution of the corporate property could take place only on their exercise. The question, then, is whether the distribution which results from the

exercise of the rights must be regarded as a dividend * * *."

To the same effect:

Choate v. Commissioner of Internal Revenue (2 Cir. 1942) 129 F.2d 684.

The decision of this Court in *Palmer* is as sound today as when it was first pronounced some 30 years ago. The rule that no dividend income is received merely on the receipt of stock rights has been firmly embedded in the tax law ever since. This has been reflected in the long-established administrative practice of the Internal Revenue Service. G.C.M. 25063 (C.B. 1947-1, 45, 47) states:

> "* * * this office is of the opinion that the stock rights * * * are taxable as dividends to the stockholders only when exercised by them. Prior to that time, there has been no distribution by the corporation and the statutory definition of a dividend has not been met."[12]

In other types of reorganizations where rights have been an incidental part of the reorganization, the courts have held that they are no barrier to a tax-free reorganization. Illustrations of this principle may be found in such cases as *Edgar J. Hesslein* (1930) 21 B.T.A. 61, affirmed per curiam (2 Cir. 1931) 53 F.2d 1081. Similarly in *George L. DeBlois et al., Executors* (1928) 12 B.T.A. 1138, affirmed (1 Cir. 1929) 36 F.2d 11, it was held that a tax-free reorganization occurred which prevented the deduction of a loss, when the shareholder was required

[12]Consistently, there is no loss sustained on the lapse of rights (G.C.M. 25063, supra, p. 48). In the instant cases, approximately 216,000 Northwest stock rights lapsed (A. 141).

to invest cash in the newly organized corporation through stock rights. There the Board of Tax Appeals stated (12 B.T.A. 1148):

> "The primary idea as to these shareholders [who invested cash] was that they should be enabled to carry on their interest in the business, and the cash requirement was incidental. No stranger could purchase the new securities at the same figure. The holder of stock rights is in a position somewhat analogous. When he buys his new stock he commingles it with the old and both old and new take the same basis on future sale or disposition."

To the same effect are *First National Bank of Champlain, N.Y.* (1930) 21 B.T.A. 415 (loss deduction denied); *Coleman v. Commissioner of Internal Revenue* (10 Cir. 1936) 81 F.2d 455 (loss deduction denied); *Albert W. Russel* (1944) 3 T.C.M. 817; and *Realty Corp.* (1946) 5 T.C.M. 868.

These cases recognize that where stock rights are an incidental corporate mechanism for effecting a reorganization, the presence of stock rights will not prevent the transaction from qualifying as a reorganization. Here, the stock rights merely accomplished the purpose of completing the divisive reorganization by permitting the distribution of the Northwest stock to the Pacific shareholders.

The *Palmer* principle was applied by the Commissioner in ruling on the tax effects of the Pacific plan of reorganization. The Commissioner stated in his ruling letter of June 28, 1961, reaffirmed on November 15, 1962:

> "The receipt by the shareholders of the Pacific Company of rights to purchase shares of stock of

the Northwest Company will not result in taxable income to the shareholders" (A. 152, 158).

The stock rights created by Pacific and issued to its shareholders were mere offers of Northwest stock. Until these offers were accepted, i.e., by exercise, there was no transfer of corporate assets by Pacific to its shareholders. The only corporate assets transferred by Pacific under the stock rights offerings were the shares of Northwest stock, which were a mere changed form of Pacific's ownership of the business and assets in the three northwest states. The mere creation and issuance of the rights by Pacific in no wise diminished its property or net worth. When the plan of reorganization was completed, far from any diminution of the net worth of Pacific and Northwest by the distribution of dividends as the Commissioner contends, the total property and net worth of Pacific and Northwest had been *increased* by the capital paid into Pacific by its shareholders in the exercise of their rights. The taxpayers received none of Pacific's assets other than the Northwest stock which, under section 355, they were entitled to receive tax free.

In holding that the taxpayers' receipt of the stock rights represented a taxable dividend (A. 321), the Ninth Circuit not only misconceives the essential nature of stock rights as *Palmer* clearly set forth, but also ignores the substance of the plan of reorganization. The rights issued in 1961 and 1963 expired within a period of approximately three weeks from the date of issuance. They were extinguished in their exercise. By their terms, they could not survive completion of the plan of reorganization. The rights were mere transitory steps to effect the distribution of the North-

west stock to the Pacific shareholders *(Helvering v. Alabama Asphaltic Limestone Co.* (1942) 315 U.S. 179, 184-185). As the Second Circuit so properly observed (A. 276-277):

> "[W]hen Pacific decided to have its assets held by two corporations instead of one, the position of the Gordons remained unchanged. They merely needed to have another piece of paper to evidence their same fractional asset ownership. This, in substance, Pacific supplied. However, as a result of the transaction, the Commissioner of Internal Revenue (the Commissioner) has assessed an income tax against the Gordons who properly ask, probably in some wonderment, how this corporate change of asset ownership brought income to them, and if so, where is it?"

The conditions laid down in section 355 were intended by Congress to prevent the distribution of earnings and profits. There is nothing here resembling any bail-out of earnings and profits. This corporate division presents no opportunity for a bail-out. On the contrary, if the Commissioner and the Ninth Circuit are sustained, ordinary dividend income will be fabricated out of the retention of taxpayers' investment in the equity of Pacific and Northwest. As the Second Circuit so rightly stated (A. 284-285):

> "Here it is evident that the taxpayers' investment remained in corporate solution (aside from the $6.36) and merely changed its form. The only additional factor was the payment of $16 per share which was in reality tantamount to a contribution to capital and that, of course, is no occasion for the imposition of a tax. Nor was there any opportunity for the taxpayers to use this transaction for a bail-out of earn-

ings and profits. On the other hand, if the Commissicner prevails, taxpayers' equity investment will be turned into ordinary income."

D. Coupling the distribution of the Northwest stock with the payment of capital to Pacific does not create taxable dividend income out of the tax-free distribution under section 355.

The exercise of the rights required the payment of cash to Pacific. The injection of this additional element in the distribution of the Northwest stock is the basis for the Commissioner's main argument that the transaction does not qualify as a tax-free spin-off.

It is beyond dispute that a distribution of all the Northwest stock to the Pacific shareholders without the payment of cash by them to Pacific would have qualified as a taxfree spin-off under section 355. It is also clear that a simple contribution of cash to the capital of a corporation by shareholders in proportion to their stock ownership cannot under any circumstances be considered to give rise to taxable income to the contributing shareholders. Thus, we have here two transactions, which separately considered would not give rise to taxable income—a contribution of capital and a distribution of the stock of a controlled corporation to the shareholders of the distributing corporation. Paradoxically, the Commissioner seeks to transmute these two tax-free transactions into taxable income.

To predicate taxable income on the exercise of rights requiring the payment of additional capital into Pacific contradicts substance and reality. Far from *receiving* any benefit in the form of cash or other property which might provide an appropriate occasion for the imposition of

a tax on income, taxpayers had *paid out* money. In doing so they merely preserved what they had before, albeit in the form of stock certificates of two corporations instead of one. In practical effect, the transactions here involved are no different than a distribution by Pacific of the Northwest shares directly to the taxpayers, accompanied by a capital assessment levied on them at the rate of $16 for each Northwest share received.

The Second Circuit properly held that Congress, in enacting sections of the Code relating to corporate changes, must be presumed to have adhered to the fundamental purpose of taxing income. Not until the taxpayers disposed of their Northwest stock would they realize anything from the receipt of such stock. As was stated by the Tax Court (A. 263):

> "But Section 355 was intended to permit the receipt of such stock without tax even where the recipient paid nothing therefor, and we think it would be a distortion of Congressional purpose to impute an intention to impose the tax where the recipient was required in effect to contribute to the capital of the distributing corporation as a condition to receiving the distributed stock."

E. The Commissioner's theory results in unrealistic tax effects from the standpoint of the incidence of the tax, the basis of the Northwest stock and the earnings and profits of Pacific and Northwest. Conversely, the tax effects of taxpayers' contentions accord with reality and do not permit any tax avoidance.

Under the Commissioner's theory, the incidence of the tax would fall when the shareholders had received no more than evidences of their continuing equity in the

spun-off business and assets, and were financially out-of-pocket. The exercise of the stock rights in actuality represented a financial burden rather than a financial benefit to the taxpayers. On the other hand, if section 355 is applied to the receipt of the Northwest stock, there will be no tax until the taxpayers sell their Northwest stock and in fact realize income out of which an income tax can be paid.

The Commissioner's theory has an added element of harshness. It converts the taxpayers' equity into ordinary dividend income. In reality, the shareholders' gain, when they do in fact realize it by sale or exchange of their equity, is and should be treated as a capital gain.

Under the Commissioner's theory, the basis of the taxpayers' Northwest stock is $16 a share (the amount paid in exercise of their rights), plus the amount treated as taxable income (A. 160). The original cost basis of their Pacific stock under his theory would remain unchanged. Such a result fails to reflect two important changes with respect to the Pacific and Northwest stock, namely, the transfer of 20 per cent of the assets of Pacific to Northwest, and the investment of an additional $480,000,000 in Pacific.

On the other hand, the application of section 355 requires an allocation of basis under section 358(b). This allocation, contrary to the Commissioner's position, would take into account not only the original investment of the taxpayers in their Pacific stock, but also the additional capital paid into Pacific. The taxpayers' total investment thus arrived at would be allocated between their Pacific

and Northwest stock in proportion to the relative market value of such stock.

A further anomaly is presented by the effect of the Commissioner's theory on the earnings and profits of Pacific and Northwest. Such earnings and profits would be reduced under section 312 by the amount of dividend income deemed to be taxable to the Pacific shareholders through the exercise of their rights, despite the fact that all of the assets and property of Pacific and Northwest were still in corporate solution and available for future distribution as taxable dividends to the shareholders. Under the taxpayers' contentions, on the other hand, the full amount of earnings and profits of Pacific and Northwest remain, as they are in fact, undiminished and subject to taxation when and as actually distributed to the shareholders.

In no way would the application of section 355 to the receipt of the Northwest stock be detrimental to the revenue; no tax avoidance would result. On the contrary, its application to the receipt of the Northwest stock would produce tax effects which accord with reality. The oft-repeated admonition that taxation is eminently practical should be heeded here, and the transactions given a tax effect which accords with practical results.

F. The spread between the offering price and the market value of the Northwest stock was the means of effecting the distribution of the Northwest stock to the Pacific shareholders and did not represent a dividend.

The Ninth Circuit's determination that a distribution of the Northwest stock for no consideration would *not* constitute a taxable dividend, but that a distribution for

a "substantial" consideration less than market value *is* a taxable dividend, presents an unsupportable anomaly.

When Pacific transferred the business and assets in the three northwest states to Northwest, the Northwest stock, which Pacific then held, represented 20 per cent of the equity of Pacific. To effect a distribution of the Northwest stock to the Pacific shareholders, Pacific had no alternative but to offer the Northwest stock to the Pacific shareholders pro rata. In establishing an offering price of $16 a share for the Northwest stock, approximately 40 per cent below the market value of the Northwest stock, Pacific aimed directly at the distribution of the Northwest stock to its shareholders by inducing them to exercise their rights.

The results achieved through the spread used in the rights offering speak for themselves. Over 95 per cent of the Pacific shareholders to whom the rights were issued received their proportionate amount of the Northwest stock through the exercise of rights. The Ninth Circuit stated, however, that the existence of the spread between the offering price and the market value of the Northwest stock evidenced an intention to declare a dividend. The reasoning of the Ninth Circuit presents an anomaly. Had the Northwest stock been offered by Pacific to its shareholders with a maximum spread, i.e., no payment of cash whatever, the Pacific shareholders would have been able to receive the Northwest stock tax free under section 355. The logic of the Ninth Circuit's reasoning compels the conclusion that a maximum amount of dividend income would result, if the offering price was a nominal amount, but income would entirely disappear if the shareholders

paid nothing. The Ninth Circuit must have been aware of the infirmity of its position, since it attempted to qualify its conclusion by referring to "substantial cash payments" (A. 326).[13] The test of substantiality of the cash required for the exercise of rights finds no support in law or in logic. The tax effect of the exercise of stock rights in a reorganization should not and cannot turn on such a vague and indefinite concept.

The Committee Reports on section 355 and the related reorganization provisions disclose a clear intent to permit divisive reorganizations to be effected with known tax consequences. The uncertainties that would result from the test laid down by the Ninth Circuit are sufficient to call for its rejection. More important is the fact that the spread between the offering price and the market value of the Northwest stock was nothing more than a means whereby a portion of the Pacific shareholders' equity in Pacific was passed on to them in the form of Northwest stock. Since they were entitled to receive, tax free under section 355, part of their Pacific equity in the form of Northwest stock, no other result is called for here.

[13]Far from supporting the Ninth Circuit's conclusion, the qualification serves to destroy it. Assuming a market value of the Northwest stock of $26 per share, the Ninth Circuit would find *no* dividend in the case of a distribution without any consideration; a dividend of $10 in the case of a distribution with a "substantial" payment by the shareholder of $16 per share; and either no dividend or a $25 dividend in the case of a distribution with a cash payment of $1 per share, depending on whether the Ninth Circuit deemed the $1 per share payment to be "substantial" or not.

G. Transferability of the stock rights does not take the transaction out of section 355.

In refusing to apply section 355 to the divisive reorganization accomplished by Pacific, the Commissioner and the Ninth Circuit make a point of the transferability of the Northwest stock rights. The Ninth Circuit did not decide that the "transferability of stock rights would, without more, run counter to the overall concept of section 355" (A. 326). It concluded, however, that Congress was unwilling to treat as tax free a distribution "effectuated by means of transferable stock rights, the exercise of which required substantial cash payments" (A. 325-326).

Section 355 could not more plainly evidence the intention to permit tax-free spin-off reorganizations, despite transferability by the distributees, than by the following provision:

> "* * * (but the mere fact that subsequent to the distribution stock or securities in one or more of such corporations are sold or exchanged by all or some of the distributees (other than pursuant to an arrangement negotiated or agreed upon prior to such distribution) shall not be construed to mean that the transaction was used principally as such a device [for the distribution of earnings and profits])" (sec. 355(a)(1)(B)).

The fact that the rights were assignable in no way alters the substance and purpose of the plan to distribute the Northwest stock to the Pacific shareholders. Consistent with the interests of the minority Pacific shareholders was the recognition by Pacific that some of the shareholders might not be in a position to exercise their rights and thereby preserve their proportionate interests in Pacific

and Northwest. Since American had expressed its intention to exercise all of its rights, transferability of its rights, representing 90 per cent of the rights issued, was academic. Transferability merely permitted some of the minority Pacific shareholders, not in a position to exercise their rights, to realize on the portion of their equity represented by the Northwest stock, through a sale of rights.

If salability of part of a shareholder's equity could defeat the operation of section 355, such a rule would void each and every attempted tax-free divisive reorganization, as the Second Circuit pointed out. The limitation of continuity of interest should be applied to the actual result, and here, continuity was fully satisfied (A. 288; cf. *Miles v. Safe Deposit Co.*, 259 U.S. 247, 253).

All of the elements of a tax-free spin-off are present in full accordance with the legislative purposes and Congressional intent of section 355. It remains only to examine the highly technical points urged by the Commissioner in his contentions that certain conditions of section 355 were not met.

II

THE DISTRIBUTION OF THE NORTHWEST STOCK BY PACIFIC CONFORMS IN ALL RESPECTS TO THE CONDITIONS AND REQUIREMENTS OF SECTION 355.

As shown above, Pacific's reorganization had all the formal aspects and all the practical and economic effects of a spin-off: part of the operating assets of Pacific were transferred to a new corporation in exchange for its

stock; that stock was transferred to Pacific's shareholders without their surrendering any Pacific stock; there was no purpose or effect of distributing earnings or profits. But instead of viewing the application of section 355 to the transaction in the light of its broad purposes, the Ninth Circuit, as a basis for its conclusion that the statutory requirements were not met, turned to a hypertechnical and narrow construction of isolated words and phrases of the section, out of harmony with the Congressional intent.

The Tax Court properly observed (A. 260) that the distribution of the Northwest stock would present a classic case of divisive reorganization under section 355, absent the use of stock rights and the receipt by Pacific of a promissory note of Northwest. But these variations from the classic form of spin-off neither disturb the substance of the transaction as a precise fulfillment of the statutory purposes embodied in section 355, nor do they violate any of the conditions or requirements of that section.

A. Pacific "distributed" the Northwest stock to taxpayers "with respect to its stock" as required by section 355 (a)(1)(A).

The essence of section 355(a)(1)(A) as it applies to the cases at bar, is:

> "If * * * a corporation distributes to a shareholder, with respect to its stock * * * solely stock or securities of a corporation * * * which it controls * * *."

The Second Circuit, relying on *Palmer,* had no difficulty in finding a distribution of the Northwest stock to Pacific's shareholders with respect to Pacific's stock. The Ninth

Circuit's theory is not so clear; at one point it concludes that the Northwest stock was not distributed with respect to Pacific's stock but was distributed with respect to the taxpayers' ownership of that stock *plus* the payment of \$16 per share (A. 320); at another point it treats the subject of the distribution as not the stock, but the rights (A. 319, 321). In neither aspect, we submit, was the court correct.

Despite the Ninth Circuit's labored construction, the phrase, "distributes * * * with respect to its stock" is a simple and obvious term. It refers simply to a distribution to a shareholder in his capacity as a shareholder. The Senate Finance Committee in its report on the 1954 Code (S.Rept. 1622, 83d Cong., 2d Sess., p. 231) so stated:

> "Subsection (a) of section 301 provides that a distribution of property (as defined in sec. 317(c)) made by a corporation to a shareholder with respect to his stock shall be treated in the manner provided in subsection (c) of section 301. Subsection (a) accordingly makes clear that section 301 has applicability *only to distributions of property to shareholders in their capacity as such*" (emphasis added).

The Treasury Regulations echo this interpretation (Income Tax Regs. sec. 1.301-1 (c)):

> "Section 301 is not applicable to an amount paid by a corporation to a shareholder unless the amount is paid to the shareholder in his capacity as such."

The essence of the plan for reorganization was that the Pacific shareholders—in their capacities as such—should receive the rights, and by answering the need for a con-

tribution of capital to Pacific, receive the stock and thus preserve their same equity in all of the assets.

The Ninth Circuit advanced an entirely new concept—which the Second Circuit observed was nowhere supported by any authority (A. 286)—that the phrase "distributes with respect to its stock" in section 355 is a term of art with a consistent meaning throughout the Code, which excludes distributions with a cash consideration (A. 320-321). We agree that the phrase is a term with a consistent meaning throughout the Code, but contrary to the Ninth Circuit, that meaning embraces distributions with a consideration, cash or otherwise.

It should be noted that section 355 does not in express terms exclude a cash consideration paid by the distributee shareholder. On the contrary, the language relied on by the Ninth Circuit, in its ordinary meaning, includes transactions in which a cash consideration is paid to the distributing corporation. The Ninth Circuit conceded that this Court in *Palmer,* over 30 years ago, said that a sale of corporate assets to shareholders is in a literal sense a distribution of its property (302 U.S. 69). (This statement was made in *Palmer,* moreover, in connection with the receipt of stock by a shareholder through the exercise of stock rights.) The Ninth Circuit brushed *Palmer* aside by saying:

> "* * * we do not believe that it is the kind of distribution contemplated by section 355" (A. 320).

On this unsupported basis, the court expressed its theory that the cash consideration disqualified the distribution of the Northwest stock as a distribution "with respect to * * * stock" under section 355.

Not only does section 355(a)(1)(A) use the term "distributes" as commonly understood to include "sales" to shareholders,[14] but by its express language it embraces "exchanges." Section 355(a)(1)(A)(ii) reads "distributes to a security holder, in exchange for its securities, solely stock or securities of a corporation." Section 355(a)(1)(A)(i) also includes exchanges, since by virtue of section 355(a)(2), a distribution thereunder may include an exchange of stock for stock in the distributing corporation. By express language, therefore, the term "distributes" in section 355(a)(1)(A) includes exchanges of stock or securities for stock (either preferred or common) and exchanges of stock or securities for securities represented by long-term notes, bonds or debentures. No reason is suggested why exchanges involving all these types of consideration would be expressly included while distributions of stock involving a cash consideration would not be included. Such an anomalous reading is wholly out of harmony with the broad purposes of section 355.

The well-understood meaning of the phrase "with respect to stock" is revealed by an examination of the parallel provisions of section 301 (ante, p. 53). Despite its contrary claim, the Ninth Circuit's conclusions that taxpayers received a dividend distribution with respect to their Pacific stock under section 301, but not a distribution with respect to their Pacific stock as provided in

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[14]It should be noted that—unlike a sale to a third party—where a cash consideration is paid by a shareholder to a distributing corporation, the shareholder through his stock ownership retains an interest in the amount of cash paid.

section 355 (A. 321), are self-contradictory.[15]

The Ninth Circuit's attempt to explain why essentially the same language in these two sections should have different meanings (A. 321) is wholly unsatisfactory. Its

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[15]In attempting to escape this contradiction, the Ninth Circuit states that the subject of the distribution was not the Northwest stock but the Northwest stock rights issued by Pacific to its shareholders without a cash consideration. In this, the Ninth Circuit not only departs from the rule of the *Palmer* case, but contradicts the very ruling of the Commissioner which it purports to uphold. The Commissioner's ruling specifically held that the subject of the distribution was not the Northwest rights but rather the Northwest stock. The applicable rulings were as follows (A. 152-153):

> "The receipt by the shareholders of the Pacific Company of rights to purchase shares of stock of the Northwest Company will not result in taxable income to the shareholders.
>
> "No taxable income will result to the shareholders of the Pacific Company by reason of holding the above-described rights to purchase shares of stock of the Northwest Company until the date of expiration of the rights, without having exercised, sold or exchanged them.
>
> "The full amount realized by the shareholders of the Pacific Company upon the sale or exchange of the above-described rights to purchase shares of stock of the Northwest Company will constitute ordinary income to the shareholder so selling or exchanging the rights.
>
> "The receipt by the shareholders of the Pacific Company of stock of the Northwest Company upon the exercise of the above-described rights, in case of each shareholder which is not a corporation, will result in a distribution of property under section 301 of the Code in an amount equal to the excess, if any, of the fair market value of the stock of the Northwest Company at the time of the exercise of the rights over the amount paid for the stock; and, in the case of each shareholder which is a corporation, will result in a distribution of property under section 301 in an amount equal to the excess, if any, of the basis of the stock of the Northwest Company in the hands of the Pacific Company at the time of the exercise of the rights over the amount paid for the stock, assuming the basis of such stock is less than its fair market value."

Since the basis of the Northwest stock in the hands of Pacific was *less* than the offering price, all of the corporate shareholders of Pacific (including American) were treated as *not* having received a dividend from Pacific upon the exercise of their rights.

mere reference to the fact that section 355 relates to a distribution of "solely stock or securities," whereas section 301 relates to a distribution of "property," provides no explanation. The Ninth Circuit's reasoning that there is a difference between sections 301 and 355 as to what the shareholder may *pay* as consideration, because of a distinction in the two sections as to what the shareholder may *receive*, is an utter non sequitur.[16] The difference in what a corporation distributes affords no definition of what the distributing corporation may receive (*Securities Co. v. Commissioner of Internal Revenue* (2 Cir. 1933) 64 F.2d 330; *Albert W. Russel* (1944) 3 T.C.M. 817; *Realty Corp.* (1946) 5 T.C.M. 868).

It is clear that the Commissioner has interpreted section 301 to include distributions involving the transfer of corporate property to shareholders for cash at less than market value. Section 1.301-1(j) of the Income Tax Regulations provides that in the case of a transfer of property by a corporation to a shareholder for an amount less than its fair market value, such shareholder shall be treated as having received a dividend under section 301. The Ninth Circuit's reasoning, that such "treatment" indicates that the transaction was not strictly a distribution under section 301 (A. 322, n. 12), simply will not bear analysis. The Commissioner's regulation is interpretative of the statute (*Timberlake v. Commissioner of Internal Revenue* (4 Cir. 1942) 132 F.2d 259). The Commissioner has no power by

[16]"Yet the payment of cash did not take the transaction out of section 203(b)(2), for the word 'solely' is aimed at what is received in exchange and not at what is handed over in order to secure participation in a reorganization" (*Securities Co. v. Commissioner of Internal Revenue* (2 Cir. 1933) 64 F.2d 330, 331).

regulation to convert into a distribution something that is not a distribution. This regulation supports the position of the Second Circuit, consistent with the *Palmer* case, that the cash consideration involved in the receipt of the Northwest stock by the taxpayers does not make such receipt any less a distribution to taxpayers with respect to their Pacific stock.

B. The transaction was not used principally, or at all, as a device for the distribution of the earnings and profits of either Pacific or Northwest (section 355(a)(1)(B)).

The major restriction on spin-off distributions carried over by the 1954 Code from prior law is the provision of section 355(a)(1)(B) that:

> "* * * the transaction [must not be] used principally as a device for the distribution of the earnings and profits of the distributing corporation or the controlled corporation or both * * *."

At no time in the presentation or argument of these cases has the Commissioner even suggested that Pacific's plan of reorganization was a device to distribute its earnings and profits, or those of Northwest. As the Tax Court held,

> "Subparagraph (B) is not involved at all since there is no contention that the transaction was used as a 'device for the distribution of the earnings and profits' of either Pacific or Northwest" (A. 260).

C. The requirements of continued active conduct of the business, both before and after the spin-off, were met (sections 355(a)(1)(C), (b)(1)(A), (b)(2)(B) and (C)).

The active business requirements set forth in section 355(b) are that the trade or business spun off must have

been conducted for the previous five years, and that such trade or business must not have been "acquired" within such five-year period "in a transaction in which gain or loss was recognized in whole or in part" within the meaning of section 355(b)(2)(C). As the Second Circuit stated, the theory underlying this requirement was the prevention of the temporary investment of liquid assets in a new business in preparation for a section 355 division (A. 289). The reasoning was that, if the new business must be operated for at least five years, there would be little incentive to use the device for tax-avoidance purposes. To safeguard against the possibility of purchasing a business which had been in existence for over five years and then distributing the stock in place of a dividend, subsections (b)(2)(C) and (D) of section 355 excluded the acquisition of a trade or business in which gain or loss was recognized.[17] Beyond question, the businesses which Pacific had conducted in the four states for many decades had to be continued after the reorganization. Further, it is undisputed that the dangers intended to be dealt with by section 355(b) were not involved in the legitimate divisive reorganization which occurred here.

Both the Tax Court and the Second Circuit held that the active business requirements of section 355 were fully satisfied (A. 269, 289). They rejected the Commissioner's contention that the business of Northwest was acquired from Pacific in a transaction in which gain was recog-

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[17]Cohen, Silverman, Surrey, Tarleau and Warren, The Internal Revenue Code of 1954: Corporate Distributions, Organizations, and Reorganizations, 68 Harv.L.Rev. (1954-1955) 393, 430; Bittker and Eustice, Federal Income Taxation of Corporations and Shareholders, 469 (2d Ed. 1966); *W. E. Gabriel Fabrication Co.* (1964) 42 T.C. 545, 557, acquiescence, C.B. 1965-1, 4.

nized and, therefore, violated the requirements of section 355(b)(2)(C). The Ninth Circuit did not consider this contention, since it had already rejected the application of section 355 on other grounds. The Second Circuit and the Tax Court, however, gave full consideration to the Commissioner's theory and found no difficulty in rejecting it in the light of the language of the statute and its clear legislative purpose. The Second Circuit stated (A. 289):

> "The second danger was that instead of creating a new business, the corporation would purchase one which had been in existence for over five years and then distribute its stock in place of a dividend. To safeguard against this possibility, subsections (b)(2)(C) and (D) prohibit acquisition of a trade or business, or of a corporation, in a transaction in which gain or loss was recognized. In our case no new business, no new assets and no new corporation was acquired at all. No liquid assets were temporarily invested nor, in fact, was there any temporary investment. Consequently, the application of these sections to the instant transaction would serve no purpose at all."

The Commissioner conceded that there was no taxable gain on the transaction to be included in the consolidated return filed by American and its subsidiaries, including Pacific and Northwest. The Commissioner's argument was that while the gain was properly "eliminated," it was nevertheless "recognized." The Tax Court gave this argument short shrift (A. 267):

> "We think that this distinction is spurious, and that the terms 'elimination' and 'nonrecognition' are intended to be synonymous in this context. Apart from the absence of any solid basis for the claimed

distinction, a careful textual examination of the statute and regulations discloses that the word 'eliminated' was used in the sense of 'nonrecognition.' "

As the Tax Court pointed out, the Commissioner's contention that gain on the transfer to Northwest was "recognized" is unsound. Throughout the Code, "recognition" and "nonrecognition" are terms which simply denote that a specified gain or loss shall or shall not be taken into account in computing income. There is no dispute that the transfer of assets to Northwest by Pacific in return for the Northwest stock, the assumption of certain liabilities and the Northwest note did not result in any taxable income. There are three insurmountable obstacles to the Commissioner's contention:

First, he must show that section 355(b)(2)(C) applies to transfers to a controlled corporation of a trade or business already owned by the parent distributing corporation and not acquired from third parties. The Second Circuit held that the prohibition in section 355 applied only to the bringing of new assets within the combined corporate shells of the distributing and controlled corporations, and that it was irrelevant as to internal adjustments of corporate assets through intercorporate transfers (A. 289).

Second, the Commissioner would have to establish that nonrecognition of gain under the consolidated return provisions (which are clearly applicable here) does not involve nonrecognition of gain or loss within the meaning of section 355(b)(2)(C). On this the Tax Court was plainly correct in its holding that there is no basis for a distinction between elimination of gain in a consolidated return and nonrecognition of gain for purposes of section

355 (A. 267). The Tax Court properly held that any gain eliminated from taxability is not recognized gain.

Third, the Commissioner would have to establish that the Northwest note was not a security. While the Tax Court and the Second Circuit found it unnecessary to decide this point (A. 266), the mere fact that the $200,000,000 Northwest note was in form payable on demand in no wise prevents it from qualifying as a security, since it represented a substantial and continuing capital interest in the corporation (*Camp Wolters Enterprises v. Commissioner of Int. Rev.* (5 Cir. 1956) 230 F.2d 555, certiorari denied (1956) 352 U.S. 826). This is evident from the fact that the $200,000,000 indebtedness was refinanced by four issues of 20-year debentures by Northwest in the amounts of $50,000,000 each during the period from 1961 to 1963 (A. 66), and the indebtedness itself originated in the purpose of the plan to provide Northwest with a capital structure having the same proportions of total debt and stock as those of Pacific prior to the transfer (A. 54). It was not feasible for Northwest to assume a prorata part of the long-term debt of Pacific then outstanding, and instead the demand note was given so that Northwest could create its own long-term debt to replace the permanent capital represented by the Northwest note given to Pacific.

On none of his hypertechnical interpretations and applications of the "active business" requirement is the Commissioner correct.

D. The distribution of the Northwest stock through two rights offerings satisfied the requirements of section 355(a)(1)(D).

For the first time before the Courts of Appeals, the Commissioner contended that section 355(a)(1)(D) required that the stock of the controlled corporation be distributed in a single distribution (A. 327). Both circuit courts considered this question of law on its merits and both rejected the Commissioner's contention.

The Second Circuit pointed out that nothing in the statute requires distribution of stock in a single offering. Section 355(a)(1)(D) simply embodies the Congressional decision that only complete and not partial divisions would receive tax-free status (A. 290). The section permits the retention of a limited amount of stock as long as such retention is not pursuant to a plan of Federal income tax avoidance. As the Second Circuit stated (A. 291):

> "[T]here is nothing on the face of this subsection that relates to the number of transactions, or their timing, which may be contained in a distribution. These matters are entirely governed by the more flexible 'device' clause of Section 355(a)(1)(B) which is fully adequate for this purpose and which clearly is no bar to the qualification of this corporate division."

The Commissioner's contention that periodic distributions of stock might be used as a substitute for dividends was considered by the Second Circuit to have no application, since the reorganization involved in the instant cases was a genuine corporate division and could not conceivably be considered to involve a substitute for dividends (A. 292). The court considered the incongruity of limiting section 355 to a single distribution when viewed

against the other provisions of Subchapter C dealing with reorganizations. Pointing to the fact that in 1961 Pacific was the eighth largest nonfinancial company in the United States, with over 38,000 shareholders, it stated that the reorganization involved the distribution of over 30,000,000 shares of Northwest stock and raised for Pacific nearly half a billion dollars. The Second Circuit found that none of the other reorganization sections imposed any requirement of a single distribution, and to impose in this case the requirement suggested by the Commissioner would be staggering (A. 293).

The rule is well established that all of the steps which are an integral part of a plan of reorganization are to be considered as parts of a single transaction. This rule has been stated by this Court in *Helvering v. Alabama Asphaltic Limestone Co.* (1942) 315 U.S. 179, 184-185:

> "Some contention, however, is made that this transaction did not meet the statutory standard because the properties acquired by the new corporation belonged at that time to the committee and not to the old corporation. That is true. Yet, the separate steps were integrated parts of a single scheme. Transitory phases of an arrangement frequently are disregarded under these sections of the revenue acts where they add nothing of substance to the completed affair. *Gregory v. Helvering,* 293 U.S. 465; *Helvering v. Bashford,* 302 U.S. 454. Here they were no more than intermediate procedural devices utilized to enable the new corporation to acquire all the assets of the old one pursuant to a single reorganization plan."

This rule, that all of the integral steps of carrying out a plan of reorganization must be treated as a single trans-

action, applies generally to all types of corporate reorganizations treated in Subchapter C of the Code. Section 355 is part of Subchapter C, and deals with all types of divisive reorganizations. The rule of *Alabama Asphaltic* therefore applies to section 355. The Commissioner, in interpreting section 355, has ruled that the step transaction doctrine, generally applicable to all types of reorganizations, applies to divisive reorganizations under section 355 (Rev.Rul. 57-311, C.B. 1957-2, 243).[18]

Without the step transaction doctrine, section 355 might be completely unworkable when applied to corporations having large numbers of shareholders. Reorganizations may take many forms. Delays in completing reorganizations may be encountered not merely because of the magnitude of the transactions involved and of the complexities of the corporate adjustments, but also because of litigation or necessary action of regulatory agencies. Mere lapse of time between the steps necessary to consummate a plan of reorganization has never been considered a basis for nonapplication of the reorganization provisions. Frequently, tax-free reorganizations are effected over a period of time which overlaps several taxable years.[19] No administrative difficulties have been encountered by the Commissioner in applying the reorganization provisions in this manner. Procedures are

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[18]Cf. *W. E. Gabriel Fabrication Co.* (1964) 42 T.C. 545, 552, acquiescence C.B. 1965-2, 5.

[19]*D. W. Douglas* (1938) 37 B.T.A. 1122, 1128 (5 years between distributions); *Roosevelt Hotel Co.* (1949) 13 T.C. 399, 407 (4 years); *Pearson Hotel, Inc. v. United States* (N.D.Ill. 1959) 199 F.Supp. 33 (15 years); *Preston Wilson* (1961) T.C.Memo.No. 1965-135, 20 T.C.M. 676, 688 (3 years); *Moffatt v. C.I.R.* (9 Cir. 1966) 363 F.2d 262, certiorari denied (1967) 386 U.S. 1016 (over 2 years).

readily available to the Commissioner to protect the revenue in the event the reorganization is not carried out in accordance with the plan of reorganization. By waivers of the statute of limitations or by the assessment of taxes and the filing of claims for refund, taxpayers' returns may be held open for final adjustment until all the steps of the reorganization have been consummated.[20]

In any event, as the Second Circuit pointed out, the enormity of the administrative difficulties may be measured in part by the failure of the Commissioner to raise this single distribution point in the Tax Court (A. 294).[21] The Second Circuit, moreover, pointed out that the Commissioner is not prevented from drafting reasonable regulations designed to ameliorate any administrative problems that might arise from more than one distribution (A. 295).

The Tax Court here properly applied the step transaction doctrine. The Tax Court found as a fact that: "There is no dispute between the parties that the two offerings were component parts of a single plan and that they must be regarded together as resulting in the disposition of 100 percent of the Northwest stock in a single

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[20]The fear expressed by Judge Friendly of the Second Circuit (A. 297-303), that permitting more than one distribution under section 355 would prevent the proper determination of tax liability on the basis of annual accounting periods, is groundless. There is no reason to distinguish in this respect between reorganizations under section 355 and reorganizations under any of the other sections of Subchapter C.

[21]Pacific requested the Commissioner's ruling on behalf of its shareholders in March, 1961. The cases were tried in the Tax Court in December, 1964, and final briefs were filed with the Tax Court in May of 1965.

transaction" (A. 255, n. 4). This finding is correct and is fully supported by the record.

The plan of reorganization contained in the proxy material (A. 100-112) and the registration statement (A. 117-127) filed with the Securities and Exchange Commission stated unequivocally that all of the Northwest shares would be distributed pursuant to the plan, which it was anticipated would be completed within a period of three years. Pacific's constant needs for new capital (A. 85) gave virtual assurance that the distribution would be completed in the time anticipated. In point of fact, all of the Northwest stock was distributed within less than two years.

The testimony on this point was compelling. Mr. John O. Einerman, the Vice President and Comptroller of Pacific who presented the plan of reorganization to the board of directors and shareholders of Pacific, testified specifically on this matter.[22] The Pacific management was faced with complex and difficult corporate and financial problems in distributing the Northwest stock to the Pacific shareholders. Mr. Einerman testified that the Northwest stock was a new security of unknown market value

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[22] [By Mr. Horrow:] "Mr. Einerman, were the offerings of rights to purchase Northwest common stock in 1961 and 1963 inseparable, one from the other?

* * * * *

"The Court: Let me ask the witness. Would the second step be taken without the first?

"The Witness: No, sir. These two steps were just part of the same plan.

"The Court: And when you took the first step, did you intend to present to the board of directors the taking of the second step?

"The Witness: Absolutely, this was basic to the plan" (A. 196-197; cf. A. 191).

(A. 205). The questions to what extent and over what period of time the Northwest stock could be absorbed by the Pacific shareholders under the rights offerings involved perplexing factual determinations. The total capital paid in to Pacific under the rights offerings was in excess of $480,000,000, over 95 percent of which was provided by the Pacific shareholders. The presentation to the Pacific directors made by Mr. Einerman illustrates the complex factual considerations involved (A. 128-138).

It was for the trier of fact, the Tax Court, to determine whether all of the steps involved in the distribution of the Northwest stock were part of a single transaction. The Ninth Circuit in finding to the contrary (A. 333) invaded the province of the Tax Court as the fact-finding tribunal.

Salutary rules limiting review of findings of fact by the courts of appeals are set forth in *Commissioner v. Duberstein* (1960) 363 U.S. 278. There the Court held that Tax Court findings cannot be rejected unless they are clearly erroneous, and such findings include factual inferences developed from undisputed facts as much as they do other findings of fact. The question whether the several steps involved in the distribution of the Northwest stock were parts of a single transaction is essentially a question of fact, not of law. This Court in *Dobson v. Commissioner* (1943) 320 U.S. 489, 502, said:

> "Whether an apparently integrated transaction shall be broken up into several separate steps and whether what apparently are several steps shall be synthesized into one whole transaction is frequently a necessary determination in deciding tax consequences. Where no statute or regulation controls, the Tax

Court's selection of the course to follow *is no more reviewable than any other question of fact*" (emphasis added).

The Ninth Circuit, as an independent reason for reversing the Tax Court, devised a new rule for the purposes of this case (A. 333):

> "[W]e think that a fair interpretation of section 355 requires that there be a single transaction in which a controlling interest is transferred and that for two or more distributions to be entitled to treatment as a single transaction transferring control of the controlled corporation to the shareholders of the distributing corporation, such distributions must not extend over any greater period of time than is reasonably necessary considering the practical problems involved in completing such distributions * * *."

The Second Circuit aptly commented on this innovation of the Ninth Circuit (A. 295, n. 9):

> "While this approach effectively compromises the harshness of the Commissioner's argument, the statute contains no such requirement."[23]

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[23] As the Second Circuit observed, the step transaction doctrine has been invoked by the Commissioner to defeat tax avoidance, by asserting that a tax-free reorganization occurred (A. 284). Congress was well aware of the possibility of using split-ups and split-offs as methods of using paper losses to establish deductions for tax purposes (H.Rept. 704, 73d Cong., 2d Sess., C.B. 1939-1 (Part 2) 563-564):

> "The subcommittee, and later the committee, made a careful study of the provisions governing exchanges and reorganizations, since it appeared that these sections had frequently been used as a means of tax avoidance. One suggested solution was the complete elimination of the provisions, with the expectation that in the course of time, by means of court decisions and perhaps new legislation, a more desirable method of

In these cases all the stock of Northwest was actually distributed in accordance with the plan of reorganization. At the time the plan was adopted, there was a fixed intention and a commitment on the part of Pacific to distribute all of the Northwest stock to its shareholders. Under these circumstances, the Second Circuit and the Tax Court properly held that the requirements of section 355(a)(1)(D) were fully satisfied.

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treatment could be built up. The Treasury believed such a procedure might result in some immediate loss of revenue, as well as in a severe handicap upon legitimate exchanges and reorganizations. Moreover, reorganizations are now being consummated in the majority of cases in order to reduce the capital structure and quite generally show a loss. In the past, the reverse was true, and reorganizations were carried out to expand the capital structure and generally showed a gain. The committee decided that, under present conditions, the wiser policy is to amend the provisions drastically to stop the known cases of tax avoidance, rather than to eliminate the sections completely. This decision will further avoid the period of litigation and uncertainty which would necessarily follow a complete reversal of the established policy."

If the application of section 355 could be excluded merely by using two distributions, a ready means of tax avoidance would be available.

III

THE SECOND CIRCUIT COURT OF APPEALS PROPERLY HELD IN DOCKET NO. 760 THAT THE SALE OF THE NORTHWEST RIGHTS GAVE RISE TO CAPITAL GAINS RATHER THAN DIVIDEND INCOME.

Taxpayers in No. 760 received 1,540 shares of common stock of Pacific. Since six rights and $16 were required for each share of Northwest, they exercised 1,536 rights, thereby acquiring 256 shares of Northwest stock, and sold the remaining four rights for net proceeds of $6.36 (A. 69). The Tax Court held that the total proceeds of sale represented taxable dividend income (A. 271). The Second Circuit Court of Appeals reversed the Tax Court, holding that the sale of the rights gave rise to a capital gain (A. 296).

The Tax Court's position was based on the fact that section 355 did not apply to the rights which were sold, and that without section 355, the distribution of the Northwest stock would have resulted in a dividend, the anticipation of which by sale resulted similarly in a dividend (A. 271). It is true that section 355 does not apply to the sale of the rights. However, as the Second Circuit pointed out (A. 296), section 355 is a statutory device for determining that a distribution of capital rather than of earnings and profits has occurred. The Northwest stock represented the equity of the Pacific shareholders in approximately 20 per cent of the business and assets of Pacific. The stock rights issued represented the Pacific shareholders' right to preserve that equity. To the extent that the taxpayers exercised their rights, they preserved their equity. To the extent that they sold their rights,

they realized on a portion of their equity. Had the taxpayers sold either their Pacific stock or the Northwest stock to which they would have been entitled on the exercise of the rights, they clearly would have realized capital gains. The taxpayers should be in no different position than they would have been in had they sold the Northwest stock itself in anticipation of the exercise of their rights. The stock rights must be equated with the Northwest stock to which they relate.

Gibson v. Commissioner of Internal Revenue (2 Cir. 1943) 133 F.2d 308 held that the proceeds of sale of rights which, upon exercise, would have given rise to dividend income, represented an anticipatory realization of that dividend income (*Helvering v. Horst* (1940) 311 U.S. 112). Applying the *Gibson* principle to this case, the Northwest stock to which the rights related was, by reason of section 355, a capital distribution, rather than a dividend distribution out of the earnings and profits of Pacific or Northwest (cf. *Miles v. Safe Deposit Co.* (1922) 259 U.S. 247). The sale of this capital interest in the form of rights is a capital transaction and should be so treated.

The treatment under section 1234(a) is analogous. Under that section, a gain on the sale of an option is treated as ordinary or capital, depending upon whether a gain from the sale of the property subject to the option would be ordinary or capital. Here it is clear that a gain on the sale of the Northwest stock, the property subject to the option (the stock rights), would be a capital gain. Similarly, gain on the sale of the stock rights, as the Second Circuit correctly held, should be treated as a capital gain.

CONCLUSION

The judgment of the Court of Appeals for the Second Circuit in No. 760 should be affirmed, and the judgment for the Court of Appeals for the Ninth Circuit in No. 781 should be reversed with directions to affirm the Tax Court.

Respectfully submitted,

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(Appendix Follows)